Inflation doesn’t let up

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Inflation doesn’t let up

Armando Castelar Pinheiro and Silvia Matos

The beginning of this year has been more challenging than anticipated. On the international front, inflationary pressures have intensified, with further increases in the prices of commodities, especially oil and agricultural goods. The rising oil price has been mainly driven by strong demand, in a context of restricted supply as a result of global decarbonization efforts. With regard to agricultural commodities, grain harvest projections have been revised downward, especially in Brazil and Argentina, due to weather problems that have affected production. Inventories of these products are low, accentuating pressure on prices.

Geopolitical tensions are exacerbating this trend. For example, Russia and Ukraine are two of the world’s biggest wheat exporters. In addition, China has avoided a more intense deceleration of the economy through stimulus policies and this has put more pressure on the prices of commodities, especially metals. In turn, the Omicron wave intensified inflationary pressures in industrial inputs by limiting production chains and helped sustain global demand at high levels in relation to supply.

In the United States, inflation has broken records going back many years. The headline rate rose to 7.5% in the last 12 months, the highest figure since 1982, and core inflation reached 6%, the highest in almost 40 years. In this context, and with the job market under pressure, expectations of tighter monetary policy have been confirmed. Despite this, the markets have shown a greater risk appetite and this has contributed to the appreciation of emerging countries’ currencies against the dollar. However, there is no guarantee that this situation will continue in the coming months.

In Brazil, international price pressures and domestic weather issues have pushed up the prices of industrial goods and household food, leading to an increase in the 12-month inflation rate in these two groups in January. Prospects are still not very favorable in the short term. The only encouraging thing is that, because of the greater flow of foreign resources into the country, the currency has strengthened around 8% since the turn of the year, mitigating external price shocks.

In any case, high inflation will remain on the radar screen for a few months, and we will only see a decline in monthly inflation once electricity prices fall, due to a rise in reservoir levels. In fact, electricity prices are expected to rise around 5.6% by the end of this year, and there are risks of further upward revisions.

In relation to economic activity, recently released indicators confirm the deceleration trend, especially in retail. In particular, the Commerce Current Situation Index dropped to 80.5 points in January, the lowest value since March 2021 (75.9 points) and well below the all-time high recorded in July 2021 (108.7 points). As highlighted in previous editions of this Bulletin, we expected this sector to shrink, due to the normalization of household consumption and recovering demand for services, to the detriment of the consumption of goods. Another reason for this decline is families’ weak purchasing power, due to high inflation, weak income growth and worsening credit conditions.

On the other hand, there is still room for the normalization of some private and public sector services. Services provided to households ended last year 11% below the pre-pandemic level of February 2020, according to our Monthly Services Survey. Public sector services, according to FGV IBRE’s GDP Monitor, ended 2021 almost 2% below the level recorded in the last quarter of 2019. There is therefore scope for a significant increase in activity in these services. Other service segments are already above or close to the February 2020 level.
In this context, we only slightly reduced our GDP growth forecast for the fourth quarter, from 0.6% to 0.5% (quarter-over-quarter). GDP is expected to grow, due to the favorable contribution of services and agriculture, more than offsetting the decline in industry. In fact, since the middle of last year, we have been upgrading our assessment of GDP growth in the last quarter of the year, following the stagnation in the second and third quarters. In addition, we believe there is still room for a positive GDP result in 2022, due to the normalization of some activities in the services sector and expectations of growth in the extractive and agricultural sectors. Despite the downward revision of agricultural sector growth in 2022, due to the more adverse weather at the beginning of the year, we still project expansion compared to last year. As a result, we have maintained our growth forecast of 0.6% for this year.

In view of this context, as well as the current stage of the monetary tightening cycle and the cumulative effects of the already occurring interest rate increases on the economy, we believe the Central Bank will reduce its pace of interest rate increases to 1 percentage point at its next meeting. In May, we envisage a final increase of 0.5 percentage points, ending the cycle at 12.25%. Compared to other countries, therefore, Brazil is ahead of the monetary tightening cycle. However, all the signs indicate the need to maintain the interest rate at this level until the end of the year. The following steps will depend on what happens to fiscal policy.

In fact, despite a positive short-term situation, fiscal risks have intensified. Following changes to the government’s spending ceiling rules, there was great uncertainty about the sustainability of the public finances. Today, the perception is that the fiscal rules may be changed when there are political pressures, often for electoral reasons, including changes that are not necessarily fair from a social point of view.

Recently, constitutional amendment proposals and bills in Congress have been moving in the direction of tax cuts, together with changes to the Fiscal Responsibility Law to avoid the need for tax compensation measures. Consequently, the spending ceiling and Fiscal Responsibility Law no longer restrict fiscal imprudence. The final impact on the public finances will depend on the scope of these measures, but the federal government’s primary deficit is already expected to deteriorate from 0.4% to 1.0% of GDP this year. However, the risk is even greater, moving the country further and further away from fiscal balance.

With these issues in mind, this edition of IBRE’s Macro Bulletin includes the following highlights:

- **Economic activity – page 7:** In December, our high-frequency indicators showed that the services sector was still doing well, industry was having a respite and retail was sluggish. We maintained our 2021 GDP projection at 4.6%, including moderate quarterly expansion of 0.5% in the fourth quarter. In 2022, we expect to see high interest rates and inflation, but there is still scope for recovery in some service segments. Therefore, growth this year is likely to be low but positive, 0.6%, given the challenges that lie ahead.

- **Business people’s and consumers’ expectations – page 9:** FGV’s confidence indexes started 2022 in decline, suggesting a slowdown at the beginning of the year. Our preliminary February data maintains this result on the business side and suggests some recovery on the consumer side. Despite improving, consumer confidence is still very low and a special item in our January survey showed that many families are behind with their debt repayments. On the business side, the highlights were declines in services, due to the impact of the pandemic’s new wave, and industry’s continuing difficulty in obtaining inputs. It is still hard to imagine getting back on the recovery path in the short term.

- **Labor market – page 12:** In November, the Continuous National Household Sampling Survey (PNADC) recorded another significant drop in the unemployment rate, from 12.1% to 11.6%, in line with FGV IBRE’s forecast. In seasonally adjusted terms, this represented a reduction of 0.2 percentage points, to 12.0%. For December, we now project another decline, to 11.2%, or 11.8% in seasonally adjusted terms. Employment continues
to grow strongly in virtually all major sectors, especially services. However, despite positive movements in employment and labor market participation, sharp declines in average income led to quarterly reductions in employment income in recent months. Meanwhile, the General Employment Registry (CAGED) indicated that 265,000 jobs were lost in December, equivalent to the creation of 210,000 jobs in seasonally adjusted terms, close to FGV IBRE’s forecast. In January, we expect 160,000 jobs to be created, or 42,000 in seasonally adjusted terms. In November 2021, CAGED and PNADC recorded similar levels of formal job creation in the year to date, having converged again over the course of 2021.

**Inflation – page 15:** On top of the effects of the previous harvest, which was marked by drought, frosts, fires, harvesting delays, rising input prices and skyrocketing oil prices, the weather continued to harm major crops in southern Brazil at the beginning of the year, especially corn and soybeans. These pressures are expected to increase food’s relative contribution to inflation in 2022. Oil prices continue to rise, given fears of an imminent war between Russia and Ukraine. Brent and WTI crude oil prices are close to US$100, having gone up 22% in 2021. Because of these pressures, food and industrial good prices should continue to rise for a few more months. This supports another revision of 2022 inflation, which according to the Central Bank’s latest Focus Report already increased from 5.0% in early January to 5.4% in early February.

**Monetary policy – page 16:** The minutes of the latest meeting of the Brazilian Central Bank’s Monetary Policy Committee make clear Central Bank leaders’ concern about prospects for inflation. Consumer inflation has been more persistent than anticipated, core inflation seems to be under pressure, the rise in industrial goods prices has not let up, oil prices have caused the Central Bank to revise upward its projection for regulated prices, and high uncertainty about the future fiscal framework remains a source of pressure on risk premiums, increasing the chance that inflation expectations will be de-anchored. In light of this, and the Central Bank’s repeated commitment to “persevere with its strategy” of monetary policy tightening, our analyst concludes that we will probably have high real interest rates for a long time to come.

**Fiscal policy – page 18:** The subject of the fiscal section is the final results of the 2021 public finances. According to the government, they indicate a structural recovery of federal revenue and an improvement of the public finances, but market analysts see a worsening of the fiscal situation and related risks. By looking in more detail at the 2021 figures, we can find clues to help understand this disagreement and support projections for 2022.

**External sector – page 20:** Methodological differences explain the significant difference between the trade balance recorded in SISCOMEX and that used in the Central Bank’s balance of payments statistics. There is uncertainty in the translation between the two methodologies, adding an extra layer of uncertainty to assessments of Brazil’s external sector situation.

**International panorama – page 23:** The topic of the international section is inflation. The biggest international risk for emerging economies in 2022 is the nature of the inflationary process in the U.S. economy. Our central forecast envisages a reversal of inflationary shocks and a gradual rise in the Federal Reserve’s interest rates, up to the level considered neutral, currently believed to be 0.5% real-terms interest per year or 2.5% in nominal terms. However, the big risk is that following the reversal of shocks, inflation could acquire inertia and remain systematically at a level above the target of 2% per year. The most important transmission channel for us to know whether inflation is acquiring its own dynamics is the evolution of wage growth. Will the American economy experience a price-wage spiral?

**Political outlook – page 24:** This month’s Political Outlook section, written by researcher Octavio Amorim Neto, is called “The Lula-Alckmin Alliance: Political Innovation in the Name of Democracy.” The Lula-
Alckmin alliance has the potential to be the biggest Brazilian political innovation since the country entered permanent crisis mode after the outbreak of nationwide protests in June 2013. This alliance represents the core of a great democratic coalition that could not only win the presidential elections in 2022 but also provide the new government with broad parliamentary support. However, there are various problems related to this grand democratic coalition. Furthermore, there is a lot of calculation and opportunism underlying the formation of this coalition. However, this time, the typical impurities of politics will contribute to a greater cause: the reinvigoration of democracy.

- **IBRE in focus – page 25**: Finally, the IBRE In Focus section, written by researcher Livio Ribeiro, looks at “China: Challenges in 2022.”
Economic activity
Situation plays out in line with forecasts
Silvia Matos, Marina Garrido and Mayara Santiago

High-frequency data in December confirmed the economic situation in the last quarter of 2021: weak industry, recovering services and weakening trade. Market projections, which were more pessimistic, are drawing closer to FGV IBRE’s projections published in previous bulletins, indicating a positive change in the fourth quarter of 2021, compared to the third quarter, in terms of aggregate GDP.

In particular, manufacturing expanded 2.0% month-over-month in December (-5.9% year-over-year), ending a sequence of six consecutive declines, considering seasonally adjusted data. However, we project a negative result for the sector in January, in line with manufacturing leading indicators. In addition, bottlenecks associated with shortages of inputs are expected to last until mid-2022, due to disrupted global production chains. Because of this and also high interest rates, manufacturing is likely to remain on a downward path until the end of the year. In December 2021, manufacturing was 5.0% below the level of February 2021, prior to the effects of COVID-19’s second wave, which as well as extreme health impacts also caused losses for the sector, which had not yet recovered from the first wave’s effects.

In turn, broad retail had a moderately positive result in December: figures released by FGV IBGE indicated growth of 0.3% month-over-month (-2.7% year-over-year), the second consecutive positive rate. However, this result came below market expectations of 0.8% growth in broad retail sales compared to November. This worse-than-predicted result was largely due to construction material sales, which shrank 1.4% in December compared to November (-8.3% year-over-year).

On the other hand, growth in the services sector was quite widespread in December, as well as in November, and the sector once again beat expectations, growing 1.4% in December compared to the previous month (10.4% year-over-year). This positive surprise indicates that the effects of reduced mobility at the end of 2021 and the beginning of this year will appear more strongly in the indicators for the beginning of 2022. This result reinforces the growth trend shown by the information technology subsector since mid-2020, which expanded 1.3% between November and December and 25.3% year-over-year. Although the subsectors most affected by the pandemic, such as services provided to families, grew more slowly in December, the situation continued to normalize. Services provided to families expanded 0.9% compared to November, the ninth consecutive increase and up 21.6% from December 2020. This subsector is now 61.6% above the level observed in the second wave (March 2021) but 11.2% below the level before the pandemic (February 2020). So, there is still room for growth.

Finally, the Brazilian Central Bank’s activity indicator, IBC-Br, rose 0.3% month-over-month in December (1.3% year-over-year). This indicator has now recorded 10 year-over-year increases in 11 months and it is 0.9% below the February 2021 level, before the effects arising from the pandemic’s second wave in Brazil. The fourth quarter result was a weak 0.3% compared to the fourth quarter of 2020 and unchanged from the third quarter of 2021. However, the Economic Activity Indicator showed monthly growth of 3.8% compared to December 2020 (1.0% month-over-month), as well as growth of 2.4% in the last quarter compared to the same period of 2020 (0.5% quarter-over-quarter). Likewise, FGV IBRE’s GDP Monitor also showed annualized growth of 3.0% (0.8% month-over-month). The GDP Monitor’s quarterly growth rate, 1.9% year-over-year and 0.7% quarter-over-
quarter, is in line with the economic recovery forecast presented earlier in IBRE’s Macro Bulletin and this result is much higher than IBC-Br.

The data supported our fourth quarter growth forecast and we have merely revised our aggregate growth estimate downward slightly, from 0.6% to 0.5% in relation to the third quarter and from 1.7% to 1.6%, year-over-year. We continue to expect a recovery in the services sector in the fourth quarter. However, as highlighted in previous editions of this bulletin, industry is unlikely to perform well. Consequently, our forecast for 2021 remains 4.6%. (See Table 1.)

On the supply side, industry, dragged down by the manufacturing subsector, is expected to end 2021 down 1.7% quarter-over-quarter and down 1.9% year-over-year.

Also on the supply side, we expect the service sector to grow 0.7% quarter-over-quarter (3.6% year-over-year), driven by other services, information services and transport. These activities are in the process of normalizing after a big drop during the crisis period, especially the transport sector, which was revised sharply upward due to the large increase in mobility at the end of the year (from 3% to 8.5%, year-over-year). In 2021 as a whole, services should grow 4.8%, equal to the carry-over effect. We have also revised public sector services downward, in line with the GDP Monitor. Finally, the financial intermediation sub-sector must have performed poorly due to the monetary tightening in 2021.

On the demand side, household consumption is expected to grow 1.2% quarter-over-quarter (2.8% year-over-year) in the fourth quarter and 3.8% in 2021. We forecast investment growth of just 0.2% (3.0% year-over-year). Imports should outperform exports: we expect growth of 6.5% quarter-over-quarter (13.4% year-over-year), compared to -2.7% quarter-over-quarter (2.9% year-over-year), respectively.

For 2022, we have maintained our projection of only 0.6% growth, slightly above the estimated carry-over effect of 0.2% for the year. We reassessed the agricultural sector, given that the end of 2021 seems to have been better for it, in addition to a reduction in the forecast grain harvest this year. Consequently, we reduced our forecast for the sector from 3.5% to 2.8%. Industry should continue to struggle and the expected rise in interest rates until the middle of the year will have an impact on demand for goods. Manufacturing is expected to shrink 3.2% this year. However, we expect the service sector to grow 1.3%, more than aggregate GDP.

We expect high interest rates in 2022. We estimate that the Central Bank will raise rates to 12.25% this year. We also project that the Extended Consumer Price Index (IPCA) will be 5.6% on average in 2022. This still high

<table>
<thead>
<tr>
<th>Activities</th>
<th>2021.IV (quarter-over-quarter)</th>
<th>2021.IV (year-over-year)</th>
<th>2021</th>
<th>2022</th>
</tr>
</thead>
<tbody>
<tr>
<td>Household Consumption</td>
<td>1.2%</td>
<td>2.8%</td>
<td>3.8%</td>
<td>0.8%</td>
</tr>
<tr>
<td>Government Consumption</td>
<td>0.7%</td>
<td>2.5%</td>
<td>1.9%</td>
<td>2.5%</td>
</tr>
<tr>
<td>Investment</td>
<td>0.2%</td>
<td>3.0%</td>
<td>17.1%</td>
<td>-3.9%</td>
</tr>
<tr>
<td>Exports</td>
<td>-2.7%</td>
<td>2.9%</td>
<td>5.7%</td>
<td>3.9%</td>
</tr>
<tr>
<td>Imports</td>
<td>6.5%</td>
<td>13.4%</td>
<td>15.0%</td>
<td>-1.0%</td>
</tr>
<tr>
<td>GDP</td>
<td>0.5%</td>
<td>1.6%</td>
<td>4.6%</td>
<td>0.6%</td>
</tr>
<tr>
<td>Agriculture</td>
<td>9.3%</td>
<td>3.4%</td>
<td>0.5%</td>
<td>2.8%</td>
</tr>
<tr>
<td>Industry</td>
<td>-1.7%</td>
<td>-1.9%</td>
<td>4.3%</td>
<td>-1.1%</td>
</tr>
<tr>
<td>Extractive</td>
<td>-2.4%</td>
<td>3.5%</td>
<td>2.8%</td>
<td>3.5%</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>-2.0%</td>
<td>-6.2%</td>
<td>4.7%</td>
<td>-3.2%</td>
</tr>
<tr>
<td>Electricity and Other</td>
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<td>-1.0%</td>
<td>-0.6%</td>
<td>0.7%</td>
</tr>
<tr>
<td>Construction</td>
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<td>8.4%</td>
<td>8.7%</td>
<td>0.0%</td>
</tr>
<tr>
<td>Services</td>
<td>0.7%</td>
<td>3.6%</td>
<td>4.8%</td>
<td>1.3%</td>
</tr>
</tbody>
</table>

Source: IBGE. Produced by: FGV IBRE.
level of inflation, even if lower than in 2021, confirms expectations of a drop in real income. We should see a continuation of the trends seen at the end of 2021, with industry still suffering from delays in normalizing international supply chains. On the demand side, because of higher interest rates, investment is likely to decline and household consumption will slow down. With stagnant domestic demand, still moderate world growth and a weak exchange rate, external demand should contribute positively to GDP this year.

**Business people’s and consumers’ expectations**

Confidence continues to weaken at the start of 2022

Aloisio Campelo, Rodolpho Tobler and Viviane Seda Bittencourt

FGV’s confidence indexes began 2022 with another drop, reaching the lowest figures since April 2021, at the end of the second COVID-19 wave. This result suggests a slowdown in economic activity, influenced by the arrival of a new wave of COVID-19, caused by the Omicron variant, particularly affecting in-person services, which had previously been recovering well.

<table>
<thead>
<tr>
<th>Confidence Index</th>
<th>Change in month (in points)</th>
<th>Current Situation Index</th>
<th>Change in month (in points)</th>
<th>Expectations Index</th>
<th>Change in month (in points)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industry</td>
<td>98,4</td>
<td>99,8</td>
<td>-1,2</td>
<td>97,1</td>
<td>-2,0</td>
</tr>
<tr>
<td>Services</td>
<td>91,2</td>
<td>89,4</td>
<td>-3,1</td>
<td>93,2</td>
<td>-5,5</td>
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<tr>
<td>Commerce</td>
<td>84,9</td>
<td>80,5</td>
<td>-3,5</td>
<td>90,0</td>
<td>2,7</td>
</tr>
<tr>
<td>Construction</td>
<td>92,8</td>
<td>90,7</td>
<td>-2,1</td>
<td>95,0</td>
<td>-5,8</td>
</tr>
<tr>
<td><strong>Business</strong></td>
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<td><strong>91,3</strong></td>
<td><strong>-4,5</strong></td>
<td><strong>91,4</strong></td>
<td><strong>-3,0</strong></td>
</tr>
<tr>
<td><strong>Consumer</strong></td>
<td><strong>74,1</strong></td>
<td><strong>66,1</strong></td>
<td><strong>0,5</strong></td>
<td><strong>80,7</strong></td>
<td><strong>-2,7</strong></td>
</tr>
</tbody>
</table>

Source: FGV IBRE.

Preliminary February figures, based on data up to February 12, show that the pace of activity continues to slow down. The downward trend in business confidence is continuing and there has been some recovery in consumer confidence. The Business Confidence Index’s preliminary result fell 1.8 points, while the Consumer Confidence Index rose 3 points.

The more widespread declines among companies show that the reduction in the pace of activity has spread, reaching segments that were previously doing well, such as services, which are also suffering from the effects of the pandemic at the turn of the year. On the demand side, despite positive signs regarding consumers in February, our confidence index still remains at an extremely low level.
Caution regarding this possible consumer recovery is justified by several factors. First, as mentioned earlier, the level of confidence is still very low. Despite the increase in the preliminary February figures, the Consumer Confidence Index is still more than 10 points below its pre-pandemic level. Another important point is the macroeconomic context of the first half of this year, with high inflation, unemployment, interest rates and household indebtedness, together with falling incomes. Finally, the pandemic situation is less favorable than it was in the second half of 2021.

In January, we asked some special questions about family indebtedness in our Consumer Survey. As shown in the table below, 32.1% of respondents said they are behind with their debt repayments. Among consumers with the lowest purchasing power (monthly household income of up to R$2,100), this proportion was close to 60%, showing that this is a big problem for families at the moment.

| Table 3: Question: Is Someone in Your Family Behind with Their Debt Repayments? (percentages) |
|---|---|---|
| Income range 1 | Yes | No | Don’t know |
| Income range 2 | 57,7 | 36,4 | 5,9 |
| Income range 3 | 23,8 | 72,4 | 3,8 |
| Income range 4 | 10,2 | 86,1 | 3,7 |

We also asked consumers the main reasons they are behind with their debts. The main reason given was “inflation,” chosen by around 30% of consumers, followed by “difficulty in earning more.” However, this was
not the case in all income group. In the lowest income range, “difficulty in getting a job” was the most mentioned factor, selected by 31.8% of consumers.

On the business side, the results have both deteriorated and converged. In January, the distance between the highest sector confidence level (industry, 98.4 points) and the lowest level (commerce, 84.9 points) was 13.5 points. In February, according to the preliminary numbers, this distance has decreased. At the time of the biggest gap, in March of last year, industrial confidence was almost 32 points above commerce confidence and 27 points above service confidence. The converging sector confidence indicators are now below the neutral level of 100 points and there are no signs of recovery for now.

Confidence in the service sector, which took longer to react after the arrival of the pandemic, has also begun to decline. This seems to be related to the worsening of the health situation at the beginning of 2022, exemplified by measures such as the postponement of carnival festivities in many cities and the return of restrictive measures in some of them. It is worth noting that service sector confidence had been recovering much faster since the second quarter of last year, supported by renewed activity in segments that require consumers to be physically present, such as bars, restaurants and tourist activities.

Industry has been slowing down since the beginning of the second half of 2021. Difficulties in obtaining raw materials continue to be a major limiting factor. In January, 21.0% of companies said they were having problems obtaining raw materials, well above the long-term average of 4.0% before the pandemic.

The first results in 2022 indicate a delicate situation for confidence indexes. Companies’ confidence has continued to worsen while consumers’ confidence is starting to recover, but only very weakly. It is hard to imagine that in the short term there will be a return to the average confidence levels observed after the second wave of COVID-19, last year, because the macroeconomic situation is still unfavorable.
Labor market

Employment and participation rates continue to improve but average income falls, dragging down overall income in recent months, while CAGED and PNADC converge

Daniel Duque

In November, the Continuous National Household Sampling Survey (PNADC) recorded another sharp drop in the unemployment rate, from 12.1% (in October) to 11.6%. In seasonally adjusted terms, this represented a much smaller reduction, from 12.2% to 12.0%. The rate in the last three months was equivalent to that projected by FGV IBRE. For December, we forecast another decline, to 11.6%, or 11.8% in seasonally adjusted terms.

[Graph 3: Unemployment Rate, 2019-21 (%)]

Thus, employment indicators are moving close to their pre-pandemic levels. As the following graphs show, while the unemployment rate recovered to the level immediately prior to the pandemic in the fourth quarter of 2021, the participation rate is expected to return to the 2019 level in the first quarter of 2022.
All the economy’s main sectors are on reasonably positive trajectories. The highlight has been the recovery in services, reflected in robust monthly job creation since April 2021.

The falling unemployment rate and increasing participation rate have boosted overall employment income. However, these movements have been counteracted by a reduction in average income, which, as shown in the following graph, was strong enough for overall salaries to record a quarterly decline in the four months to October 2021.
Meanwhile, the General Employment Registry (CAGED) indicated that 265,000 formal jobs were lost in December (25,000 lower than FGV IBRE’s forecast), equivalent to the creation of 210,000 jobs in seasonally adjusted terms. In January, we expect a significant slowdown, with 160,000 jobs created, or around 42,000 in seasonally adjusted terms.

In recent months, PNADC has shown a rapid acceleration in formal job creation, and its numbers have recently been similar to those of CAGED. As shown in the graph below, the two surveys diverged considerably in...
2020 but converged in the three months to November 2021, indicating the creation of around 3 million jobs in the last 12 months.

In January, the Extended Consumer Price Index (IPCA) went up 0.54%, the highest result for this month since 2016, reflecting inflationary pressures of two types. Some are temporary, associated with seasonal factors, while others are more persistent, related to cost transfers from industry and service providers.

Seasonal effects, caused by normal weather phenomena in the summer, contributed to higher prices of fresh foods, especially tubers, roots and vegetables, whose rate jumped from -5.5% in December to 8.7% in January; and vegetables, which went up with 8.1% in price, compared to 0.1% in December. As a result, these two items accounted for 36% of the “food at home” subgroup’s 1.4% increase, up considerably from 0.8% in Dec 2021.

On top of the effects of the previous harvest, which was marked by drought, frosts, fires, harvesting delays, rising input prices and skyrocketing oil prices, the weather has continued to harm major crops in southern Brazil this year, especially corn and soybeans. The recovery of these longer-cycle crops is slower and the effects of reduced supply can materialize in the form of higher prices of derived foods and proteins. Chicken and pork, for example, are fed on products made from such commodities.
According to the U.S. National Oceanic and Atmospheric Administration (NOAA), the La Niña phenomenon is expected to continue until April of this year, so the weather is unlikely to be beneficial to agriculture until the end of the first quarter of 2022. Consequently, we have revised our estimate of food inflation this year from 4% to around 6%.

Another portion of IPCA was boosted by increases in the prices of durable goods (from 12.9% to 13.8%), semi-durable goods (from 10.5% to 11.5%) and services (from 4.8% to 5.1%). These items’ 12-month price increases confirm that inflationary pressures are spreading.

Bottlenecks in production structures and sharp rises in electricity (27%) and fuel (44%) prices in the last 12 months continue to put pressure on industrial production and service provision costs, stimulating transfers. Among durable goods, the 12-month rate reached its highest level since January 2000, when it was 14.8%. Among semi-durable goods, inflation is at its highest level since September 2003, when it was 11.7%. Finally, the growth in unregulated service prices hasn’t been this high since July 2017, when it was 5.4%.

The future of industrial good prices and unregulated service prices is uncertain, due to supply chain bottlenecks, the prices of electricity and fuel, and the trajectory of interest rates.

When it comes to electricity, the prospects are improving, as reservoir volumes are increasing, so lower power price surcharges should be possible from May onward. On the other hand, oil prices continue to rise. Due to fears of an imminent war between Russia and Ukraine, Brent and WTI crude oil prices are approaching US$100, having gone up 22% in 2021. The Brazilian real has strengthened around 8% so far in 2022, and this will offset some of the rise in oil prices, but Petrobras will not be able to put off further increases in diesel and gasoline prices for long. Finally, the rise in base interest rates, which could reach 12.25% per year in May, will curb demand even more and contribute to a gradual deceleration of prices.

Given these risks, the prices of industrial goods and services should continue to rise for a few more months. This supports another revision of 2022 inflation, which according to the Central Bank’s latest Focus Report already increased from 5.0% in early January to 5.4% in early February.

**Monetary policy**

Justifications for hawkish signs in minutes of latest Central Bank meeting

José Júlio Senna

What at first appeared to be a dovish decision soon turned out to be the opposite. In this section, we discuss the justifications for a hawkish stance on the part of the Brazilian Central Bank and, based on this analysis, we present our view on the future of real interest rates.

In its most recent Monetary Policy Committee meeting, when discussing the next steps for monetary policy, the Central Bank decided to reduce the base interest rate’s pace of adjustment, “reflecting the current stage of the tightening cycle, whose cumulative effects will be manifested in the relevant time horizon.”

Reducing the rate of adjustment in base rates, at a time when inflationary pressures are still strong and inflation expectations are not fully anchored, may seem to indicate that the bank is not very committed to bringing inflation down to its target.
However, two factors justify this decision. First, real interest rates are already at a very restrictive level. Measured by the difference between the one-year fixed rate, that is, the pre-360 swap rate, and inflation expectations 12-months ahead, as set out in the bank’s Focus Survey, the real interest rate is currently above 7.0% per year.

Second, monetary policy only entered contractionary territory relatively recently. In fact, it was only at the beginning of August of last year that, in line with the aforementioned metric, monetary tightening really started, that is, the real interest rate exceeded the rate considered neutral by the Central Bank. Until then, the bank had merely withdrawn monetary accommodation gradually. For the new policy phase to produce effective results, it is necessary to sustain this tightening and wait longer, given the lags with which monetary policy operates.

However, we must not ignore the fact that the inflation situation is worrying. This means that the Central Bank may have to further tighten its policy. In our view, insofar as this proves to be really necessary, the Central Bank will be opting for the most recommendable path. Faced with statements like this, some may ask the following question: Why, in a country so much richer than Brazil, whose economy has recovered well from the health crisis, does the U.S. Federal Reserve act with great care, to avoid aborting the economic recovery, while Brazil’s monetary authority is acting more aggressively?

The answer has to do with the fact that inflation expectations are well behaved in the United States. The general public and market agents in particular do not expect inflation to become deeply embedded. In Brazil, the picture is different. For 2023, implicit inflation in financial contracts has fluctuated around 5.6%. The median analysts’ expectation is 3.5%, while the target is 3.25%. An FGV IBRE’s consumer survey revealed expectations of 10% inflation for the next 12 months, though the questionnaire did not specify a particular price index.

Therefore, the probability of permanently higher inflation expectations taking deep root seems much higher in Brazil than in the United States. Leaving a tight monetary policy adjustment for later would only increase the cost to society as a whole.

Let us now move on to the points that seem to concern the Brazilian Central Bank. In the aforementioned minutes, the bank noted that inflation “continues to be more persistent than anticipated” and surprisingly large price rises had been observed in items “more associated with underlying inflation” – something that always causes discomfort. Regarding the behavior of industrial good prices, Central Bank officials said that these price increases “have not abated and they are likely to persist in the short term.” International oil prices are certainly a source of concern and they have already led the Central Bank to revise its regulated price forecasts upward.

Perhaps more significant is the observation that when discussing future prospects, the Central Bank still considers that the balance of risk for inflation presents “upward asymmetry” due to unease over fiscal policy. High uncertainty about the fiscal situation has resulted in “increased risk premiums and a higher risk that inflation expectations will be de-anchored.”

In short, the Central Bank is fully aware of the seriousness of inflation risks and, given its repeatedly stated willingness to “persevere with its strategy until the disinflation process is embedded and expectations are anchored around the targets once again,” it seems that we will have high real interest rates for a long time to come.
A quick glance at Brazil’s 2021 final fiscal results could easily suggest a country whose public finances had improved significantly compared to the previous year. For example, the central government’s primary deficit was just 0.4% of GDP, the consolidated public sector surplus was 0.75% of GDP and gross government debt dropped 8.3 percentage points. The federal government, through its Economic Policy Secretariat, has argued that these numbers reflect a structural recovery in federal revenue and an improvement of the public finances. However, this has not been the perception of economic agents, as confirmed in a survey prior to the Central Bank’s Monetary Policy Committee meeting of February 2022, in which 69% of institutions indicated a worsening in their perceptions of the fiscal situation and fiscal risks. By looking in more detail at the 2021 figures, we can find clues to help understand this disagreement and support projections for 2022.

To start with, it is worth comparing expectations at the beginning of the year with what actually happened. In the case of the primary result, in March 2021, when the 2021 Annual Budget Law was signed, the federal government projected a primary deficit of R$215 billion, based on net revenue of R$1.30 trillion and primary expenditure of R$1.52 trillion. National Treasury projections, published 40 days after a review in December, indicated a primary deficit of just R$35 billion, net revenue of R$1.58 trillion and expenditure of R$1.61 trillion.\footnote{It should be noted that 40 days before, in its Extemporaneous Primary Income and Expenditure Assessment Report, the government projected revenue of R$1.57 trillion and expenditure of R$1.66 trillion, resulting in a primary deficit of R$90 billion.} It can therefore be seen that the better-than-expected primary result came about mostly from unexpected revenue growth and not from expenditure restraint.

Comparing the 2021 results with those of 2020, we can see that in constant values deflated by the Extended Consumer Price Index (IPCA), net revenue grew 21.2% while total expenditure fell 23.6%. With regard to revenue performance, first it is worth noting that IPCA is not appropriate to adjust the entire tax revenue base for inflation, given that some taxes are linked to production dynamics. The adoption of a price index that better captures producers’ circumstances, such as IGP-M, would cause the real change in revenue to drop to 3.1%. Thus, even though no single price index is capable of encompassing the dynamics of all tax collection bases, we should bear in mind that the current deflation carries remnants of inflation.

Irrespective of the price index used, there is no doubt that net revenue grew in 2021. However, it is necessary to pay attention to the factors that led to this growth. First, the base effect had a positive contribution, as in 2020 there was a combination of an economic downturn and tax payment deferrals, lowering the basis of comparison. In addition to generalized inflation, which artificially expanded the tax base, higher commodity prices and Brazil’s currency devaluation boosted the performance of sectors such as fuel, metallic minerals and metallurgy. Finally, there were some major non-recurring factors, in particular R$40 billion of atypical corporate income tax revenue. Furthermore, the Financial Transactions Tax (IOF) rate for credit operations was reduced to zero between April and December 2020, and it was subsequently increased between September and December 2021. On the ex-
penditure side, the end of COVID-related measures provided some one-off opportunities for adjustment. Of the real drop in total expenditure of R$522 billion between 2020 and 2021, around R$511 billion (98%) corresponded to the withdrawal of spending executed to tackle the pandemic in its first year.

Looking at the public sector as a whole, the primary surplus of R$64.7 billion in the consolidated public sector was due to the strong performance of state governments, which had a surplus of R$74.8 billion, and municipal governments, which had a surplus of R$19.1 billion. However, as in the case of the central government, this result was also linked to temporary factors. On the revenue side, there were three major factors: i) an increase in transfers from the federal government, from both the state and municipal participation funds, due to growth in income tax revenue (the main basis for calculating these funds), as well as increased transfers related to mining and oil production, as a result of rising commodity prices and currency devaluation; ii) the inflow of non-tax revenues, including from the Rio de Janeiro Water Company (CEDAE) concession, which provided the state government with around R$18.2 billion; and iii) the excellent performance of the Tax on Circulation of Goods and Services (ICMS), whose main items benefited from inflation, especially fuel. While revenue grew, there were also some temporary factors limiting expenditure. The main one was the ban on pay rises until December 31, 2021, imposed by Law 173 of 2020. In 2022, we expect a significant increase in personnel spending at state and municipal levels, in order to restore government employees’ loss of purchasing power due to high inflation in this period. At the same time, there is no certainty that the factors that boosted revenue will be repeated.

The fact that the strong fiscal results in 2021 were due to temporary factors makes it prudent to look at 2022 more pragmatically. Thus, when analyzing the 2022 budget, which already foresees a primary deficit of 0.8% of GDP, some points stand out. For example, some questionable assumptions were used, such as a 2.1% GDP growth forecast, while the market median is 0.3%. Furthermore, while there were R$3.2 billion worth of vetoes that removed resources from areas such as labor, public pensions and education, we also saw the release of resources for electoral reasons, such as the rapporteur-general’s amendments and Electoral Fund amendments. Likewise, discussions around fuel-related constitutional amendment proposals, which are aimed at solving a problem with an external origin through taxation, seem to ignore the present fiscal risks, by giving up tax revenue and even increasing spending, in a context in which current resources no longer cover obligations and high-priority areas have been sacrificed.

One of the lessons of 2021 is that expectations at the beginning of the year may end up being very far from the result at the end of the year. This surprise is not necessarily always positive, so raising spending and making commitments based on uncertain and temporary factors can be a dangerous bet. It is true that every projection has some degree of uncertainty and is subject to revisions. Even so, it must always be supported by premises aligned with reality, and not mere rhetoric.
In January 2022’s Macro Bulletin, we highlighted some major differences between 2022 trade balance projections, based on the SISCOMEX methodology (used by the Economy Ministry) and the Central Bank’s methodology (used by the bank to calculate the balance of payments). While the Economy Ministry forecasts a record trade surplus of US$79.4 billion this year, the Central Bank envisages a much smaller surplus, of just US$51.0 billion.

It is perfectly possible for different government agencies to have different assessments, depending on their assumptions, the predictive models used and their own perceptions of the situation. However, the differences mentioned above go far beyond that, as they have a methodological nature. In 2021, for example, the trade balance according to SISCOMEX was US$61.2 billion, while in the balance of payments statistics used by the Central Bank, it was just US$36.2 billion. An overview of these differences in the recent past are shown in the table below.

### Table 4: Trade Balance
(SISCOMEX vs. Central Bank methodologies, actual results and forecasts)

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade balance</td>
<td>35,2</td>
<td>26,5</td>
<td>50,4</td>
<td>32,4</td>
<td>61,2</td>
<td>36,2</td>
<td>79,4</td>
<td>51,0</td>
</tr>
<tr>
<td>Exports</td>
<td>221,1</td>
<td>225,8</td>
<td>209,2</td>
<td>210,7</td>
<td>280,6</td>
<td>283,8</td>
<td>284,3</td>
<td>276,0</td>
</tr>
<tr>
<td>Imports</td>
<td>185,9</td>
<td>199,3</td>
<td>158,8</td>
<td>178,3</td>
<td>219,4</td>
<td>247,6</td>
<td>204,9</td>
<td>225,0</td>
</tr>
</tbody>
</table>

Source: SISCOMEX and Brazilian Central Bank.

We can clearly see that both the export and import numbers are different in the two methodologies, but the biggest differences occur in imports. This difference has been growing. In 2019, imports as calculated by the Central Bank methodology exceeded imports as calculated by the SISCOMEX methodology by US$13.4 billion. This figure then rose to US$19.5 billion in 2020 and US$28.2 billion in 2021. For 2022, the two government organizations’ projections suggest that the difference will fall to US$21.1 billion, although we do not know how to assess the assumptions implicit in both models.

How are these differences accounted for? We know that the concepts mainly differ in the way they account for special operations (in the REPETRO, REPETRO-Sped and RECOF regimes), marketplace-based transactions (low-value international purchases and sales, often between individuals) and cryptoassets (as goods, i.e., non-financial assets, following international statistical recommendations\(^2\)). An inventory of these differences is pre-

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sent below (Table 5). In recent years, the rise in imports under the REPETRO regime and the growing exposure to cryptoassets explains much of the lower trade result using the monetary authority’s methodology.

Table 5: Details of Methodological Differences
(SISCOMEX vs. Central Bank methodologies)

<table>
<thead>
<tr>
<th></th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
<th>2021</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Exports of goods – SISCOMEX</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Adjustments to balance of payments</td>
<td>7,6</td>
<td>4,7</td>
<td>1,5</td>
<td>3,2</td>
</tr>
<tr>
<td>(-) Goods sent abroad for processing / returning abroad after processing, without changing ownership</td>
<td>-0,3</td>
<td>-0,4</td>
<td>-0,3</td>
<td>-0,4</td>
</tr>
<tr>
<td>(+) Goods changing from resident to non-resident ownership, without crossing the border – REPETRO</td>
<td>7,4</td>
<td>4,3</td>
<td>0,7</td>
<td>1,1</td>
</tr>
<tr>
<td>(+) Goods changing from resident to non-resident ownership, without crossing the border – other operations</td>
<td>0,1</td>
<td>0,1</td>
<td>0,1</td>
<td>0,1</td>
</tr>
<tr>
<td>(+) Cryptoassets – change of ownership from resident to non-resident</td>
<td>0,0</td>
<td>0,0</td>
<td>0,0</td>
<td>0,0</td>
</tr>
<tr>
<td>(+) Low-value exports via international orders and operations via payment facilitators</td>
<td>0,4</td>
<td>0,6</td>
<td>1,0</td>
<td>2,2</td>
</tr>
<tr>
<td>(+/-) Exports of goods for merchanting</td>
<td>0,1</td>
<td>0,0</td>
<td>0,0</td>
<td>0,1</td>
</tr>
<tr>
<td><strong>Exports of goods – Central Bank</strong></td>
<td>239,5</td>
<td>225,8</td>
<td>210,7</td>
<td>283,8</td>
</tr>
<tr>
<td><strong>Imports of goods – SISCOMEX</strong></td>
<td>185,3</td>
<td>185,9</td>
<td>158,8</td>
<td>219,4</td>
</tr>
<tr>
<td>Adjustments to balance of payments</td>
<td>10,8</td>
<td>13,3</td>
<td>19,6</td>
<td>28,2</td>
</tr>
<tr>
<td>(-) Goods received from abroad for processing / returning from abroad after processing, without changing ownership</td>
<td>-0,4</td>
<td>-0,3</td>
<td>-0,3</td>
<td>-0,4</td>
</tr>
<tr>
<td>(+) Goods changing from non-resident to resident ownership, without crossing the border – REPETRO</td>
<td>7,2</td>
<td>6,8</td>
<td>12,5</td>
<td>15,4</td>
</tr>
<tr>
<td>(+) Goods changing from non-resident to resident ownership, without crossing the border – other operations</td>
<td>1,0</td>
<td>0,8</td>
<td>0,6</td>
<td>1,5</td>
</tr>
<tr>
<td>(+) Cryptoassets – change of ownership from non-resident to resident</td>
<td>1,0</td>
<td>3,0</td>
<td>3,3</td>
<td>6,0</td>
</tr>
<tr>
<td>(+) Low-value imports via international orders and operations via payment facilitators</td>
<td>2,0</td>
<td>3,0</td>
<td>3,5</td>
<td>5,7</td>
</tr>
<tr>
<td>(+) Electricity without exchange rate coverage</td>
<td>0,0</td>
<td>0,0</td>
<td>0,0</td>
<td>0,0</td>
</tr>
<tr>
<td><strong>Imports of goods – Central Bank</strong></td>
<td>196,1</td>
<td>199,3</td>
<td>178,3</td>
<td>247,6</td>
</tr>
</tbody>
</table>

Source: Brazilian Central Bank.

Therefore, there is additional uncertainty in the Brazilian external sector projections. As if all the known challenges in terms of defining possible trajectories for fundamentals (growth differential, terms of trade and behavior of the real exchange rate) were not enough, we now need to evaluate specific operations in order to translate the commercial projections made using the SISCOMEX methodology into the figures that will be used in the balance of payments statistics.

As we pointed out in last month’s Macro Bulletin, such a translation is quite complicated. We do not know how long there will be a residue of REPETRO operations (although they are expected to decline further), and
it is reasonable to assume that we are experiencing a change in preferences, involving the expansion of cryptoassets operations over the years.

In the absence of a “structure,” we have used SARIMA class models to translate the “SISCOMEX trade figures” into the “Central Bank trade figures.” Projecting the trade balance, which is part of our current account models, therefore follows a two-stage procedure: first, the monthly SISCOMEX result is projected (using prices, volumes and economic fundamentals), and then, applying strictly statistical models, the result is translated using the Central Bank’s methodology.

Our most recent projection for the SISCOMEX trade result in 2022 indicates a surplus of US$44.0 billion, down sharply from last year. This projection is significantly lower than the US$79.4 billion projected by the Economy Ministry. We forecast much lower exports and higher imports. Using the Central Bank methodology, we project a trade surplus of US$34.4 billion, which is also lower than the US$51.0 billion suggested by the monetary authority. In this case, however, the difference is entirely explained by exports. (See Table 6.).

<table>
<thead>
<tr>
<th>SISCOMEX Economy Ministry</th>
<th>FGV IBRE</th>
<th>Central Bank</th>
<th>FGV IBRE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade balance</td>
<td>79,4</td>
<td>44,0</td>
<td>51,0</td>
</tr>
<tr>
<td>Exports</td>
<td>284,3</td>
<td>258,2</td>
<td>276,0</td>
</tr>
<tr>
<td>Imports</td>
<td>204,9</td>
<td>214,2</td>
<td>225,0</td>
</tr>
</tbody>
</table>

Source: Economy Ministry and FGV IBRE.

Either way, we see the official export projection (whether based on the SISCOMEX methodology or the Central Bank methodology) as overly optimistic. We envisage declining terms of trade over the course of this year, with falling average export prices, so export volumes would have to grow a lot compared to last year to produce such positive trade results. Based on robust evidence of exports’ low exchange rate elasticity, tightening global monetary policy, further disruption of global supply chains, logistical shocks and fears about growth in our main trading partners, it seems to us that this would be an unlikely achievement.
The biggest international risk for emerging economies in 2022 is the nature of the inflationary process in the United States.

In our central forecast, following the incredible set of shocks that hit the American economy and also the global economy in 2020 and especially in 2021, these shocks will reverse in 2022 and 2023. Our baseline scenario assumes that inflation will fall to levels close to the target once the shocks have reversed.

If this central scenario materializes, the Federal Reserve will merely have to gently raise interest rates to the level considered neutral, currently believed to be 0.5% per year in real terms or 2.5% in nominal terms.

The U.S. labor market is on track to reach the same degree of tightening seen in February 2020 in late 2022 or early 2023. Most metrics indicate that the labor market was operating at full capacity or even just beyond full capacity from February 2020 to the first quarter of 2023.

Thus, the process of normalizing interest rates – raising them to the neutral rate of 2.5% under the benign assumption that, following the reversal of shocks, inflation will return to the target – should occur more quickly. If the Federal Reserve raises the federal funds rate 0.25 percentage points at every meeting, the upward cycle will go on until mid-2023. It no longer seems impossible that the Fed will accelerate this and increase the rate by 0.5 percentage points, at least at some meetings.

However, the big risk is that after the shocks have reversed, inflation could acquire inertia and remain systematically at a level above the target of 2% per year. If this happens, the Fed will have to take the federal funds rate into contractionary territory and cause a slowdown in growth, which will be more intense the more inertia the inflationary process gains.

Thus, in 2022 we will have to monitor the reversal of the various shocks. Everything suggests that ports, freight and container movements will improve considerably in the first half of the year. Thermal coal and gas prices, especially in Europe and Asia, should normalize over the course of the year, if nothing too serious happens in Ukraine. The supply of non-automotive chips should normalize during the year, followed by the supply of automotive chips in 2023. Oil price normalization is likely to occur later, in 2023 or 2024.

The most important transmission channel for us to know whether inflation is acquiring its own dynamics is the evolution of wage growth. In this regard, the latest (January) data from the Atlanta Fed’s Wage Growth Tracker suggests that salary increases have spread. Annual pay rises have been lower than inflation (5% versus just over 7%, respectively), but there has been a clear acceleration in wage growth.

Will the American economy experience a price-wage spiral?
Political outlook

The Lula-Alckmin Alliance: Political Innovation in the Name of Democracy

Professor Octavio Amorim Neto, FGV EBAPE

The Lula-Alckmin alliance has the potential to be the biggest Brazilian political innovation since the country entered permanent crisis mode after the outbreak of nationwide protests in June 2013. This alliance represents the core of a great democratic coalition that could not only win the presidential elections in 2022 but also provide the new government with broad parliamentary support.

This grand coalition should gradually form in 2022 and early 2023 (if it wins in October), forming an arc that goes from center-right to left. If it does materialize, it will be the end product of an arduous negotiation process. For it to truly deserve being called a grand democratic coalition, it must include PT, PSB, PSOL, PCdoB, PDT, Cidadania, MDB, PSDB and PSD. If the Lula-Alckmin ticket wins, it is also likely to negotiate with the main parties in the Centrão bloc.

Why is this an innovation? Because it brings together leaders from two parties in different ideological camps who spent two decades fighting for the leadership of the executive branch: the center-left PT and the center-right PSDB. This is unusual, given that democracy is based on electoral competition between parties with different ideologies. However, there are times when competition must give way to active inter-party cooperation for the survival of democracy itself.

Democracy has come under direct threat from President Bolsonaro. Although he has failed in his attempts to subjugate the other branches of government and tear up the Constitution, Bolsonaro’s movement will continue to exist even if its leader is defeated in October. We do not know how strong the Bolsonaro-supporting extreme right will emerge from the polls, so it is essential for democratic parties to converge now to maximize their chance of victory and provide the broadest possible political base for a future president committed to reinvigorating democracy, tackling a severe economic and social crisis, and restoring several public policies destroyed by Bolsonaro (related to the environment, foreign policy, education, culture and science). Only a Lula-Alckmin alliance meets these conditions. João Doria, Sergio Moro and Ciro Gomes are divisive figures with little chance of winning. They could attract clientelist parties, but they would find it hard to form a grand democratic coalition.

Looking at the medium term, one of the problems with the Lula-Alckmin alliance is the likelihood of a Christian Democrat like Alckmin joining the Socialist Party. A center-right politician in a center-left party means more confusion in our already very confused party system. Ideally, Alckmin should have gone to PSD, a center-right party led by Gilberto Kassab, so that this party could then make a deal with Lula. However, everything indicates that Kassab would only agree to negotiate with Lula from a slightly stronger position, i.e., if his party has its own presidential candidate. In other words, Kassab and PSD will only tend to join Lula-Alckmin in the second round. This has increased the chance of Alckmin moving to the Socialist Party, an odd move but one that is typically Brazilian. This is just one an example of how winding the path of this grand democratic coalition will be.

There are several other problems, which will be analyzed in future articles. However, it should be noted that the innovation brought about by the Lula-Alckmin alliance will only fully bear fruit if the inter-party cooperation it expresses is cemented more by programmatic commitments than by pragmatic or physiological ones. In the 2003-2016 period, Lula, Dilma Rousseff and PT made the blunder of maintaining legislative majorities by co-
opting conservatives through unorthodox methods. The rest is history. The grand democratic coalition that Lula and Alckmin are currently trying to assemble, once victorious at the polls, will have the hard task of producing a coalition agreement explaining the orientation that will be given to key government policies. The definition of policies must precede the choice of people to head the ministries.

If it materializes, the grand coalition led by Lula and Alckmin will to a large extent result from a hard-won lesson, namely the disastrous consequences caused by the savage political competition between the main parties that created and sustained the post-1985 democratic regime. The election of Bolsonaro in 2018, the threats he has made to the constitutional order since then, the failure of his government to fight the pandemic and the destruction of fundamental public policies ended up concentrating minds. A recent interview with Aloizio Nunes, a former leader of PSDB, made it clear that a lesson had been learned when he said, “During the 2018 campaign, there was no clear awareness of the danger posed by Bolsonaro. This move by Lula today is absolutely legitimate. It's in his nature. The extremist in this campaign is Bolsonaro, and he is the one we have to defeat. We have to try to stop him from reaching the second round.”

Of course, there is a lot of calculation and opportunism underlying the formation of the grand coalition discussed above. However, this time, the typical impurities of politics will contribute to a greater cause: the reinvigoration of democracy.

*This article expresses the author's opinion and does not necessarily represent FGV's institutional opinion.*

**IBRE in focus**

**China: Challenges in 2022**

Livio Ribeiro

**Bottom line**

Despite positive surprises at the end of 2021, the Chinese government has been increasingly concerned about the performance of the economy and it has made adjustments to keep the 2022 GDP growth rate at an “acceptable level.” Based on stimulus measures already in place, we project growth of only 5.0% this year. We remain more negative than the market median, which has been converging with our forecast.

In Chinese astrology, the tiger is considered the king of animals – a symbol of power and leadership, proactive and determined. The years ruled by its sign are perceived as having good omens, suitable for major developments and problem solving. There is a risk, however, of excesses, transforming determination into impulse and aggression. That is the case with 2022.

For several quarters, the Chinese government has been playing a markedly proactive role in managing the economy and society, tackling imbalances in specific sectors, shaping behavior and changing the rules that govern the

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4This article is a condensed version of a paper by BRCG called “O que esperar de 2022 | China: Os desafios do ano do tigre.” Available at https://bit.ly/3rTV9EX.
activities of economic agents. There are some noble reasons involved, such as reducing the aggregate debt of the economy, promoting access to housing at fair prices, combating the COVID-19 pandemic and protecting digital privacy. According to many analysts (especially Westerners), there are also some less encouraging motivations, such as an increase in the tentacles of state control and the weakening of opponents – of the regime, and especially of the Communist Party.

With numerous changes occurring together and the most diverse shocks, it would be reasonable for the economy to suffer. And in fact, after a remarkable V-shaped recovery in 2020, China’s economy began to weaken in 2021. (See Graph 9.) Despite signs of less dynamism in 2021, GDP growth was 8.1%. This annualized expansion was built on a very favorable comparative basis, given that in 2020, at the height of the COVID shock, the Chinese economy only grew 2.2%.

On the demand side, growth was especially driven by consumption (in both the public and private sectors), which contributed 5.3 percentage points to growth. With the dominance of consumption as a growth vector, last year was marked by a reconciliation with the strategy of an economic transition toward the domestic market. Furthermore, investment only contributed 1.1 percentage points to GDP, even lower than that observed in 2020 and the lowest since 1989-1990. China’s well-known regulatory burden and major shocks to the production chains have taken their toll. We will talk more about that later.

On the supply side, mirroring demand, the biggest contribution to last year’s growth, 4.4 percentage points, came from the tertiary sector (services). Once again, the transition toward services was seen. Something that seems counterintuitive, given the performance of investment, is the behavior of the secondary sector, which made a major contribution of 3.1 percentage points to last year’s growth. However, a closer look shows that almost the entire contribution of the secondary sector came from manufacturing. Regulatory tightening, specifically in the real estate sector, had a strong impact on construction in 2021.
Looking specifically at the fourth quarter of 2021, there was year-over-year expansion of 4.0%. This result was stronger than expected by the markets and better than our forecast (both 3.3%), implying 1.7% GDP growth between the third and fourth quarters, in seasonally adjusted terms.

On the one hand, the sharp slowdown in annualized growth in the second half of the year was confirmed, strongly affected by the comparative base. On the other hand, the good result in the fourth quarter of 2021 increased the carry-over effect for 2022, which we calculate to be 1.9 percentage points. This is down from recent years (with the evident exception of 2021, in which the comparative basis distorted the results), but not so different from the pre-COVID pattern. (See Graph 10.) All other things being equal, the strong fourth-quarter result increased our 2022 GDP growth forecast by 0.2 percentage points.

Despite the positive surprises at the end of last year, which could suggest a less difficult situation this year, the Chinese government has repeatedly expressed concern about the performance of the economy in 2022. These statements, previously limited to vague remarks, have been replaced with clear comments and effective pro-growth policies: the current motto among the Chinese authorities is “stabilization of growth at acceptable levels.”

Wouldn’t such a change in tone be nonsensical, after what was described in the previous paragraphs? In our view, no: even incorporating the surprises, our forecast for GDP growth this year is only 5.0%. Our assessment is below median market expectations and seems to be more in line with the “concerned” tone of the Chinese authorities.

But why such low growth in 2022? We understand that there are three main reasons to support concern about the behavior of the Chinese economy this year, and it seems to us that the change to a more active stance by the government is fully justified.

First, a closer look at current economic indicators (at the end of 2021 and beginning of this year) shows that the performance of the Chinese economy is indeed weak. Looking at 2021, Table 7 presents the behavior...
of annualized growth of the main components of Chinese GDP (from the supply point of view). It works like a heat map: the red figures indicate that growth was lower than at the end of 2019, while the green figures indicate that it was higher.

### Table 7: Year-Over-Year GDP Growth

*(selected components, supply)*

<table>
<thead>
<tr>
<th></th>
<th>2019T4</th>
<th>2020T1</th>
<th>2020T2</th>
<th>2020T3</th>
<th>2020T4</th>
<th>2021T1</th>
<th>2021T2</th>
<th>2021T3</th>
<th>2021T4</th>
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<tr>
<td>GDP</td>
<td>6.0</td>
<td>-6.8</td>
<td>3.2</td>
<td>4.9</td>
<td>6.5</td>
<td>18.3</td>
<td>7.9</td>
<td>4.9</td>
<td>4.0</td>
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<tr>
<td><strong>Secondary</strong></td>
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<td>GDP</td>
<td>6.0</td>
<td>-6.8</td>
<td>3.2</td>
<td>4.9</td>
<td>6.5</td>
<td>18.3</td>
<td>7.9</td>
<td>4.9</td>
<td>4.0</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>4.8</td>
<td>-10.1</td>
<td>4.6</td>
<td>6.3</td>
<td>7.4</td>
<td>26.8</td>
<td>9.2</td>
<td>4.6</td>
<td>3.1</td>
</tr>
<tr>
<td>Construction</td>
<td>4.9</td>
<td>-18.2</td>
<td>7.0</td>
<td>7.3</td>
<td>5.8</td>
<td>22.8</td>
<td>1.8</td>
<td>-1.8</td>
<td>-2.1</td>
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<tr>
<td><strong>Tertiary</strong></td>
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<tr>
<td>GDP</td>
<td>6.9</td>
<td>-5.4</td>
<td>1.8</td>
<td>4.2</td>
<td>6.6</td>
<td>15.6</td>
<td>8.3</td>
<td>5.4</td>
<td>4.6</td>
</tr>
<tr>
<td>Transport and storage</td>
<td>5.7</td>
<td>-13.6</td>
<td>2.0</td>
<td>4.3</td>
<td>8.0</td>
<td>32.1</td>
<td>12.7</td>
<td>5.9</td>
<td>4.0</td>
</tr>
<tr>
<td>Commerce</td>
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<td>-17.5</td>
<td>1.6</td>
<td>3.6</td>
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<td>26.6</td>
<td>9.6</td>
<td>7.6</td>
<td>5.9</td>
</tr>
<tr>
<td>Accommodations and food</td>
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<td>-21.7</td>
<td>-8.7</td>
<td>-0.8</td>
<td>43.7</td>
<td>17.1</td>
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<td>6.0</td>
<td>6.8</td>
<td>5.9</td>
<td>5.4</td>
<td>4.1</td>
<td>4.0</td>
<td>5.5</td>
</tr>
<tr>
<td>Real estate activities</td>
<td>2.1</td>
<td>-7.6</td>
<td>2.4</td>
<td>4.6</td>
<td>4.9</td>
<td>21.4</td>
<td>7.1</td>
<td>-1.6</td>
<td>-2.9</td>
</tr>
<tr>
<td>Information technology</td>
<td>18.6</td>
<td>14.6</td>
<td>17.3</td>
<td>20.1</td>
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<td>21.2</td>
<td>19.5</td>
<td>17.1</td>
<td>11.5</td>
</tr>
<tr>
<td>Leasing and commercial services</td>
<td>10.0</td>
<td>-6.7</td>
<td>-5.3</td>
<td>-4.2</td>
<td>4.8</td>
<td>7.9</td>
<td>5.8</td>
<td>5.8</td>
<td>5.6</td>
</tr>
<tr>
<td>Other services provided</td>
<td>7.1</td>
<td>-2.0</td>
<td>-1.1</td>
<td>2.1</td>
<td>4.4</td>
<td>8.8</td>
<td>6.2</td>
<td>5.2</td>
<td>5.0</td>
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<tr>
<td><strong>Source:</strong> NBS.</td>
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</table>

It is clear that the Chinese economy has been losing momentum since mid-2021, with the multiplication of red areas in the table. It is also obvious that the sectors linked to construction and real estate intermediation are particularly fragile, with year-on-year declines since the middle of last year.

If we leave GDP and look at high-frequency data, the growth difficulties become even more evident. It is symptomatic that indicators of industrial production and real retail (deflated by the CPI) are very close to the levels observed before the pandemic. There is no sign of a strong acceleration in demand, and even supply, in this case represented by industrial production, has clearly slowed down over the past year. The situation is even more dramatic if we turn to indicators related to construction, specifically new construction and sales volumes, which are both well below pre-COVID levels. (See Graph 11.)
It should also be noted that we do not have any “real” information about the beginning of 2022. As always, the quantitative data for the first two months will be released together and it will only be available in March. However, we do have the qualitative indicators of the PMIs (both the official NBS and the private one produced by Markit/Caixin) for the beginning of 2022, and they do not tell a good story, indicating that manufacturing is shrinking and service growth is slowing down.

Second, there are “fundamental issues” in the Chinese economy: much of the poor performance over the course of 2021 resulted from increasing constraints on the functioning of the economy, affecting both demand and supply. In the case of demand, there are increasing signs of moderation in absorption, whether internal (domestic consumption) or external (foreign consumption).

Part of this stems from specific factors – for example, the severe lockdowns imposed in China and the progressive reduction in global demand – and part stems from more idiosyncratic issues, such as Chinese families increasing their short-term savings to rebuild the assets spent during the most critical period of the pandemic. Regardless of motivation (temporary or structural), the fact is that demand seems to be low. One simple way to identify this is to look at the behavior of selected items in the NBS manufacturing PMI (Graph 12): imports, new production orders and new export orders have been in negative territory since mid-2021.
On the supply side, China has been facing severe imbalances in its production infrastructure over the last few months. Part of this derives from the “zero-COVID” policy implemented by the government: at the slightest sign of an outbreak, extensive lockdowns are imposed, disrupting supply chains, lengthening the logistical shock and bringing enormous uncertainty to the planning of economic agents (companies and families).

In parallel, the country’s industries faced significant restrictions on the supply of basic inputs in 2021, notably fuels (coal and diesel) and electricity. After signs of normalization in the fourth quarter of 2021, there has been a clear worsening of the situation in recent months. There is a major mismatch between energy demand and supply under way, on top of logistical shocks, increasing costs throughout production chains and depressing the growth of the economy.

Finally, the regulatory agenda has been affecting the preferences of Chinese economic agents, modifying established investment patterns, increasing uncertainty and, at some level, also affecting the generation of added value in the short term. Home sales indicators tell a mixed story: on the one hand, there was no real estate market (and economic) collapse after the Evergrande event, as many feared, but on the other hand, it also seems clear that home sales have not consistently returned to the levels seen before the regulatory crusade. Confidence in bricks and mortar hasn’t ended, but it has experienced “adjustments” caused by policies implemented by the government.

With that, we come to the last point: the regulatory agenda is now in place. Evidently, the best-known elements of the regulatory crusade have happened in real estate, including policies designed to reduce developers’ indebtedness and increase the average Chinese citizen’s access to housing, especially in large cities. The impacts on volumes have already been described above: regulatory changes are affecting both new construction and sales, implying adjustments on both the supply side of real estate and the demand side.

The question that arises is not one of direction, but of magnitude. Any there any grounds to believe in a reversal of the real estate squeeze, reversing this negative vector for the economy in 2022? If history serves as a guide, it seems not yet. Compared to the last major real estate tightening event (2014-2016), the decline in the sector’s indicators still seems timid. This is not so obvious in volumes, but it is quite clear in prices: there is less pressure on the prices practiced in the 70 largest Chinese cities, although in magnitude and diffusion they are lower than those observed in the mid-2010s.
It is also important to note that increased scrutiny of the real estate sector is not the only restrictive factor at work. There is a veritable crusade under way, with tentacles reaching other sectors such as education, healthcare, financial innovations and technology companies. It is more difficult to extract the eventual “real” impacts of these measures. However, it is easier to measure the effects on the stock prices of listed companies. The collapse of the Shanghai Stock Exchange’s sector indexes (Graph 13) speaks for itself.

**Graph 13: Shanghai Stock Exchange Sector Indexes**

(2019=100)

Given all these pressures and negative signals, it seems safe to say that the Chinese government is reeling from the effects. Since mid-November 2021, there has been a marked change in the authorities’ tone, from a resolute application of the regulatory agenda to a growing concern with the performance of the economy in the short term.

It is important to note that there has been an escalation following the strategic meetings of the Central Economic Work Conference (December 11, 2021) and the National Development and Research Committee (December 15, 2021). Seldom has the Chinese government been so vocal and explicit. In 2022, it will be necessary to: (i) guarantee economic stability and guarantee growth at an acceptable level; (ii) deepen reforms on the supply side, while expanding the domestic market; (iii) improve the quality of supply chains, ensuring the smooth circulation of goods and services in the economy; (iv) implement a state-led innovation strategy; and (v) promote strategic self-reliance, especially in high-tech sectors.

More than words, there are already adjustments in the fiscal, monetary and credit fields, with the clear objective of supporting growth in 2022. Early execution of bond issuance quotas by subnational governments, cuts in the economy’s benchmark interest rates, a reduction in reserve requirements for banks and a certain loosening of loan conditions, notably in shadow banking, are part of a major adjustment, seeking to avoid a more pronounced slowdown this year.

In conclusion, we consider it fully justifiable that the Chinese authorities are expressing greater concern about the growth of the economy in 2022: the high-frequency indicators, the substantive issues (internal and
external) and the restrictive effects of the regulatory crusade still in progress suggest major challenges for maintaining growth at “acceptable levels” this year. Of course, the size of support needed depends on understanding what “acceptable levels” are.

According to our models, and in the absence of new shocks, the stimulus measures already announced will be enough to keep the economy growing at around 5.0% in 2022. To reach higher levels, positive surprises seem to be necessary. Specifically, we are having a particularly fragile start to the year, with projections for year-over-year expansion of only 3.5% in the first quarter of 2022 and 4.8% in the second quarter. These numbers are lower than the most recent market median, but we emphasize that analysts’ views have been progressively converging with our numbers.
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